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LLC directors in Saudi Arabia – do they have fiduciary duties?

While the KSA Companies Law is generally silent and provides no detailed provisions on issues relating to the management of LLCs, this does not mean that the KSA courts will conclude that directors[1] of LLCs have no duties to the company or its shareholders. The courts will supplement the existing law by drawing upon specific laws applying to other types of companies by analogy and *Shari'a* to plug the gaps. In our view, as a result, directors of LLCs in KSA have broadly the same fiduciary duties as those codified in the UK.

Article 168 of the Kingdom of Saudi Arabia (KSA) Companies Law (Companies Law) is clear that directors are jointly liable to a company and its shareholders for damages resulting from malpractice. However, beyond that, many lawyers and directors believe that because the KSA's Companies Law is generally silent on the fiduciary duties of a director a director owes no duties or obligations to the company or its shareholders under KSA law. This is wrong.

In the current economic climate, shareholders worldwide – including in KSA – are scrutinising the transactions and commercial decisions of the management of underperforming companies in more detail. It is therefore imperative that directors are aware of their duties and obligations when accepting any such office.

This article highlights certain principles of *Shari'a* and other statutory obligations in relation to the fiduciary duties and liabilities of a director in KSA. It also examines these duties with reference to the UK Companies Act 2006 (Companies Act). We also provide an overview of certain obligations and liabilities imposed under the KSA Companies Law and other legislation on a director (Table 3).

Key topics

[1] Referred to generally as "managers" for a limited liability company (**LLC**) while "directors" is used for a joint stock company (**JSCs**).

KSA's legal system

Saudi law is based on Islamic law (*Shari'a*). The two main sources of *Shari'a* are the Qur'an and the writings detailing the Prophet Mohammed's (PBUH) sayings and actions (known as *Sunnah*). *Shari'a* is the basis of KSA's constitution.

In *Shari'a* there are four main schools of jurisprudence, namely: *Hanbali*, *Hanafi*, *Shafai* and *Malaki*. The KSA courts and judicial committees generally apply the *Hanbali* school of jurisprudence.

The KSA government issues decrees, laws, rules, resolutions and regulations with the objective of supplementing *Shari'a* when the need arises.

The relationship between KSA legislation and *Shari'a*

In the UK, if a statute conflicts with common law or its principles, the law would not be distinguished, overruled or set aside. By contrast the opposite may happen.

Shari'a interacts with KSA law in a number of ways:

- generally, enacted law is interpreted with regard to *Shari'a* principles and rules
- if there is a conflict between *Shari'a* and the laws enacted by the KSA government, *Shari'a* will, generally, prevail
- where enacted rules and regulations are silent, any gaps therein may be supplemented by reference to the relevant rules under *Shari'a*.

Table 1 illustrates some general pervasive principles of *Shari'a*.

Where are the fiduciary duties set out?

Unlike in the United Kingdom the KSA legislature has not codified the law in relation to the various fiduciary duties of directors in the Companies Act.

The duties, liabilities and obligations of directors in relation to KSA companies (JSCs and LLCs) are contained in a suite of documents and legislation, including:

- the Companies Law (mainly for JSCs) supplemented by resolutions and circulars issued by the Ministry of Commerce & Industry ("MOCI")
- the company's constitutional documents (the articles of association of LLCs and by-laws of JSCs) as well as shareholder agreements (if any)
- other laws and regulations relating to directors.

When considering the extent of directors' duties it is important to remember that there is no concept of judicial precedent in KSA which means that the decisions of a court or a judicial committee technically have no binding authority in respect of another case on the same facts. There is also no pervasive formal system of court reporting, although, there has been a push to increase transparency and the courts started to publish more judgments (including online). Given the lack of precedents and reporting it is not always possible to reach a conclusive interpretation of KSA law and anticipate how a competent court or committee would view a particular claim.

KSA Companies Law

The Companies Law (enacted by Royal Decree No. M/6 of 1385H as amended) governs eight forms of companies and is considered to be the first attempt to regulate companies in KSA. It was enacted in 1965 and although it has been periodically amended many believe that it still needs to be updated. A draft of a new Companies Law has been under review for a number of years now.

In KSA the two most popular types of corporate vehicles are the LLC and the JSC (public and closed). The JSC is the equivalent of a UK public limited company (listed or unlisted) and the Companies Law has numerous provisions relating to the duties and obligations of its directors. Directors of JSCs which are either listed, an authorised financial advisor or a bank, will also find themselves regulated by the many rules set out in the Listing Rules, the Corporate Governance Rules, the Authorised Persons Rules of the Capital Markets Authority in KSA and the rules of the Saudi Arabian Monetary Authority.

In practice, foreign entities usually set up in KSA through LLCs because it is quicker and easier, the liabilities of the shareholders (except in certain circumstances) are limited to the shareholders' capital contribution and they are less administratively burdensome to operate than JSCs.

A director's authority generally encompasses all transactions and business relating to the LLC's business activities. According to the model articles of association suggested by the MOCI, specific transactions may, however, be subject to the prior approval of the shareholders. If the LLC has more than 20 shareholders, then a supervisory board consisting of at least three shareholders has to be formed to supervise the general manager, executive manager or board. The powers of directors are usually set out in the articles of association of the LLC and annotated in the commercial registration certificate, thereby putting the world on notice of their powers and authority (or in a separate resolution of the shareholders usually passed at the outset of an LLC's existence).

Key provisions of a director's duties under the Companies Law

One of the key provisions in the Companies Law which creates potential liabilities for a director is Article 168 which states:

"*Shareholders may remove [directors] appointed in the Company's Articles of Association or in a separate contract without prejudice to their right to compensation if the removal is made at an improper time or without acceptable justification. The [directors] shall be jointly responsible for damages sustained by the Company, or the shareholders, or third parties as a result of the [directors] violating the provisions of these Regulations or of the Company's Article of Association, or of wrongful acts committed by them in the performance of their duties. Any provision to the contrary shall be considered void*.

The Company's consent to relieve the [directors] of liability for their management shall not entail forfeiture of the right of the Company to institute an action in liability. Such action shall be disregarded after the lapse of three years from the date of such wrongful act."

Table 3 sets out some of the other specific duties and penalties imposed on directors under the Companies Law and other legislation.

What are the duties?

Article 168 therefore confirms that a director owes a duty and that he may be liable for a breach of such duty to the company, the shareholders or third parties. It also specifies that this duty is that a director must:

- act within the scope of his power.

Further, we may also infer that "wrongful acts" in this context may in certain circumstances also include a director:

- not acting honestly
- abusing his power
- not exercising care and skill in undertaking his duties
- not acting in the best interests of the Company.

To whom does a director owe the duties?

- the company
- the shareholders
- third parties - although it is not clear whether the third party or only the company can bring a claim against the director for loss suffered.[2]

Who is liable?

- The Companies Law is clear that all directors are jointly liable for damages attributed to their "violations" or "wrongful acts" under Article 168.
- There is an argument under *Shari'a* (which is supported by Article 76 of the Companies Law in relation to JSCs) that unless the director:
  – was not aware of the resolution or
  – voted against the resolution (recorded in the minutes) or
  – upon finding out about the resolution, lodged his objection

  that all directors shall be liable even if the director was absent from the meeting or unable to vote (if he knew about it).

When does a claim need to be made?

A legal action derived from Article 168 must be initiated within three years of the date that the plaintiff became aware of the director's violation or wrongdoing.

Ratification by the shareholders?

On the face of it, it may seem that both Articles 168 (for LLCs) and 76 (for JSCs) of the Companies Law appear to reject the possibility that shareholders can specifically ratify wrongful acts carried out by the directors. We believe that this is not the intention of these provisions of the Companies Law. The intention must be that shareholders may ratify specific actions of their directors but that a generic ratification/release (rather than a specific and certain one) which is given in practice by all shareholders annually even if any violation or wrongdoing has not occurred or was not known to the shareholders would probably not be sufficient to release the directors.

Duties on liquidation of the LLC

The directors will continue to manage the company and will be deemed to act as liquidators vis-a-vis third parties until the liquidator is formally

[2] This should be read in the context of Article 167 which limits the responsibility for directors to acts within their published powers. If a third party suffered damage because they acted outside the scope of their powers, then such third party may have recourse personally against the directors.

appointed.[3] The powers of the directors formally cease from the moment that the shareholders resolve to liquidate the LLC or the relevant court or judicial body issues an order to liquidate it and appoints the liquidator.

Duties implied from other Company Law provisions

By analysing those duties which are imposed on directors of other types of company we believe that by analogy a KSA court would also impose them on an LLC director. In Table 2, we reference various Articles of the Companies Law that impose fiduciary duties (as referred in the Companies Act) which we believe also apply to a director.

Duties under *Shari'a* law

Many commentators believe that corporate governance is based on "agency" theory - the separation of ownership and management (principal and agent) i.e. in the context of an LLC, the separation of the shareholders as owners and the directors involved in managing the affairs of the LLC. The principles at the heart of corporate governance require accountability, transparency, fairness and responsibility. From the perspective of *Shari'a* it is possible to examine the different roles of a director depending on different circumstances. For example, a director could be viewed as an agent (*wakil*) of the shareholders and trustee (*emin*) and manager (*mudarib*) of the shareholders' assets.

A duty of care is imposed by *Shari'a*[i] upon people in positions of responsibility or authority. In the case of a director, in our opinion it is likely that *Shari'a* requires a director:

- to act within the scope of powers vested in him (and not abuse such powers) and fulfil his duties[ii]
- to act with a duty of loyalty and to treat all shareholders fairly (subject to anything expressly permitted to the contrary in the articles of association or shareholders' resolutions)[iii]
- to act in a trustworthy manner; with honesty and transparency – and taking into account the *Shari'a* principle which prohibits self-dealing by agents or employees (we believe that a director is under a duty not to benefit from a conflict of interest)[iv]
- to act to the best of his ability in the best interests of the LLC and in a reasonable manner as a responsible director would act[v]
- to be accountable[vi].

How to protect directors?

The common civil law remedy against directors for a breach of their powers and duties is damages.

Injunctive relief and specific performance are rarely available as judicial or adjudicative remedies to prohibit or require a director to take action under KSA Law.

Similar to the UK, the directors would endeavour to protect themselves in a multitude of ways including:

- seeking shareholder approval or ratification of specific wrongful actions
- obtaining an indemnity in certain circumstances from the company for actions taken without clear power or authority or in the amount of damages, awards and the costs attributed to defending a claim and
- obtaining a directors' and officers' (D&O) insurance policy to cover them against damages, awards and costs.

Unlike the UK, it is unusual to see provisions detailing how and when a director of the company would be indemnified for his actions or can avail himself of insurance.

It is a principle of *Shari'a* that contractual damages are only payable to cover losses which have actually been incurred. Indemnities are commonplace in Islamic legal documentation, but a contractual indemnity will generally only be enforceable for the value of an actual loss and where such loss has been caused directly by the indemnifying party to the indemnified person. Furthermore, considering that Article 168 of the Companies Law does state that any provision which does not hold the directors liable for their wrongful acts is void, a shareholder may try to argue that an indemnity should be invalidated and is unenforceable.

Under *Shari'a*, insurance contracts may be viewed as void on the grounds that they involve elements of uncertainty, usury speculation and gambling. It is likely that an obligation to effect or maintain insurance which contains provisions incompatible with *Shari'a* would be unenforceable in KSA. That said if payable on a term basis or other *Shari'a* - compliant basis then there would be no reason why a director or an LLC could not avail itself of D&O insurance from a KSA insurance provider.

[3] The LLC's shareholders will also continue to perform certain supervisory functions throughout the liquidation.

Conclusion

The fiduciary duties of a director in KSA are similar to those that apply in the UK.

Even though the KSA legislature may not have envisaged the LLC becoming the corporate vehicle of choice in KSA, with the passage of time it has become so. This has also been made possible by regulating directors and protecting those they act on behalf of or interact with, not by re-drafting the Companies Law but by applying provisions of the KSA Companies Law that apply to other types of company to LLCs by analogy and improvising further by applying *Shari'a* to modern corporate life to fill the gap.

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[i] We have set out *Shari'a* principles relating to fiduciary duties in the following footnotes. These duties and others can be derived from a general rule of agency under *Shari'a* law. In particular the agent must act within the scope of his authority as an agent in the best interest of his principle.

A judge at a KSA court would decide agency related issues on a case-by-case basis relying on the general *Shari'a* agency rule.

Please note that although we have set out *Shari'a* principles in relation to certain fiduciary duties these would apply to other duties set out in this section.

[ii] Covered under the principles of *Shari'a* such as:

“Do not misappropriate one another's property unjustly, nor bribe the judges, in order to misappropriate a part of other people's property, sinfully and knowingly.” (Quran 2.188)

“O believers! Do not betray the trust of Allah and His Rasool, nor violate your trusts knowingly.” (Quran 8.27)

“Except those … who honored their treaties with you in every detail and aided none against you. So fulfill your treaties with them to the end of their term…” (Quran 9.4)

“An agent authorized to do a specific act; e.g., authorized to accept specific country’s notes (e. g., US dollars, Saudi Riyals . . . etc.) in the sale of an item, must act in accordance with the Principal’s authorization.” (volume 5 pages 224 and 228 Al Sharh Al Kabeer – authority on comparative Islamic jurisprudence)”

[iii] Covered under the principles of *Shari'a* such as:“*…give back the trusts to their rightful owners, and when you judge between people, judge with fairness…*” (*Quran 4.28)*

“ … give just measure and weight, not withhold from the people the things that are their due..” (*The Qur'an 11:85*)

[iv] Covered under the principles of *Shari'a* such as:

“Righteous businessmen will be raised on the Day of Judgement." (Prophet Mohammed PBUH)

“A truthful merchant will be raised on the Day of Judgement together with the truthful and the martyrs.” (Prophet Mohammed PBUH)

“O believers! When you deal with each other in lending for a fixed period of time, put it in writing. Let a scribe write it down with justice between the parties.” (Quran 2.282)

“An agent authorized to buy or sell an item is not permitted to buy or sell to/from himself.” (volume 5 page 221 Al Sharh Al Kabeer – authority on comparative Islamic jurisprudence)

[v] Covered under the principles of *Shari'a* such as:

"Seek knowledge from cradle to the grave" (Prophet Mohammed PBUH)

“An agent authorized to buy/sell must do so at market fair/prevailing price, if there is no price specified by the principal.” (volume 5 page 209 Al Sharh Al Kabeer)

[vi] Covered under the principles of *Shari'a* such as:

“An agent authorized to buy or sell an item at a specific price/value would be liable to the principal for covering the discrepancy between the actual price at which he buys/sells and the price originally specified/authorized by the principal.” (volume 5 page 225 Al Sharh Al Kabeer)

"each one of you is a guardian, and each guardian is accountable for everything under his care." (Prophet Mohammed PBUH)

“*He is the One Who has made you the inheritors of the earth and raised some of you in ranks over others so that He may test you in what He has given you*.” *(Quran 6.165)*

Table 1: General pervasive principles of *Shari'a*

PRINCIPLES OF FAIRNESS	Contracting parties must maintain principles of fairness and equity in their dealings. Contracts where one party gains unjustly at the expense of another are considered voidable at the option of the injured party. In each contract the commercial substance of the transaction must be analysed to evaluate whether or not it would amount to unjust enrichment under *Shari'a*.
EVERYTHING IS PERMITTED UNLESS EXPRESSLY PROHIBITED	Contracting parties are free to negotiate the terms of their contracts unless those terms relate to activities which are expressly prohibited under *Shari'a*.
SPECULATION	Contracts which involve speculation (*maisir*) are not allowed (*haram*) and are therefore considered void. The speculation that is prohibited under *Shari'a* is not general commercial speculation (which is evident in most commercial transactions) but speculation which is akin to gambling, more particularly, gaining something by chance rather than by productive effort.
UNCERTAINTY	There should be no element of deception or uncertainty (*gharar*) in the contract. Where there is uncertainty as to the fundamental terms of a contract, such as the subject matter or price, such contracts could be considered as void.
OWNERSHIP AND RISK	It is a feature of *Shari'a* that the owner of an item bears any risk in relation to the item. Accordingly, as a general remark, it should be noted that risk cannot pass unless ownership passes. That said, risk can pass without ownership passing where (i) a person is in the business of looking after/protecting/maintaining the asset left in his care; or (ii) the asset is damaged by a negligent/wrongful act of the custodian.

Table 2: Snapshot comparison of fiduciary duties in KSA compared to UK

DUTIES	UK	LLC	JSC AND OTHER COMPANIES LAW REFERENCE
Duty of a director to act in accordance with the company's constitution and only exercise powers for the purposes for which they are conferred.	✓ Statute	✓ Statute	✓ Statute
Duty of a director to act in a way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as whole and in doing so have regard to various matters.	✓ Statute	✓ *Shari'a* / statute	✓ *Shari'a* / statute
Duty of a director to exercise independent judgment.	✓ Statute	✓ *Shari'a*	✓ *Shari'a*
Duty of a director to exercise reasonable care, skill and diligence.	✓ Statute	✓ *Shari'a*	✓ *Shari'a*
Duty to avoid a situation in which the director has or can have a direct or indirect interest that conflicts or may possibly conflict with the interests of the company (duty to avoid conflicts of interests).	✓ Statute	✓ *Shari'a*	✓ *Shari'a* / statute
Duty not to accept benefits from third parties conferred by reason of the director being a director.	✓ Statute	✓ *Shari'a*	✓ *Shari'a*
Duty to declare interests in proposed transactions of the company.	✓ Statute	✓ *Shari'a*	✓ *Shari'a* / statute

Table 3: Overview of directors' duties under Companies Law

OBLIGATIONS
The Companies Law imposes a number of legal obligations on directors over and above their obligations under the Articles of Association. The most significant of these are as follows: - Within 30 days of the formation of the LLC: (a) the publication of an abstract of the Articles of Association in the Official Gazette and (b) the registration of the LLC in the Companies Register at the Ministry of Commerce & Industry and the Commercial Register. These registrations need to be updated as required, e.g. if the Articles are amended. - Maintenance of a register showing the names of shareholders, the number of shares held by each of them and the transactions affecting such shares. - Within four months after the closing date of every financial year, the preparation of a balance sheet and a profit and loss statement. The director must send a copy of these documents to the Ministry of Commerce & Industry and to every shareholder together with a copy of the auditor's reports and the Supervisory Board's report (if applicable). - If the LLC incurs losses amounting to 50% or more of the LLC's share capital, the directors must call a shareholders meeting within 30 days to consider whether the LLC should continue to exist or be dissolved. - Calling a shareholders' general meeting at least once a year, and within six months after the closing date of the financial year of the LLC, for the purpose of approving the financial statements.
LIABILITIES
Directors are jointly responsible for damages suffered by the LLC, the shareholders or third parties as a result of the directors violating the provisions of the Companies Law or of the Articles of Association, or of any wrongful acts committed by them in the performance of their duties. It is not possible to contract out of this provision or for the shareholders' to discharge this liability. Claims against directors under this provision are time-barred after three years. Directors are liable to fines of up to SAR20,000 or imprisonment of up to one year for certain offences, including: - intentionally overestimating the value of contributions in kind - receiving or distributing fictitious profits to shareholders or third parties - intentionally falsifying the balance sheet, the profit and loss statement or reports with the intention of concealing the financial position of the LLC from the shareholders or third parties - failing to observe the mandatory rules issued under the Companies Law and related regulations or decisions - failing to comply with instructions issued by the Ministry of Commerce & Industry, without justifiable cause. Lesser offences carrying a fine of up to SAR5,000 include failing to ensure that all documents issued by the LLC bear its name and other specified details, failing to submit required documents to the Ministry of Commerce & Industry and hampering the auditor's work.

RESPONSIBILITIES UNDER OTHER LAWS
Other laws in KSA may also apply to directors in the performance of their duties, including:[4] - *Labour Law* requiring employees to keep employer's trade secrets confidential - *Commercial Books Law* which imposes statutory requirements on commercial entities to retain commercial books (e.g. inventory journals and general ledgers) - *Anti-Commercial Fraud Law* which imposes liability on directors and others for the sale of products not conforming to approved standard specifications - *Anti-Money Laundering Law*, under which directors could be liable to imprisonment (up to two years) and fines (up to SAR500,000).

[4] There are other important laws to our target clients such as the CML and its implementing rules and the banking control law and its I rules, the new finance regulations, the telecom law, insurance law etc.

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